



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
GREAT NORTHERN RAILWAY COMPANY }

Appearances:

For Appellant: Chaffee Hall of Earl and Hall and Gerdes,
its Attorneys
For Respondent: Frank M. Keesling, Franchise Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of the Great Northern Railway Company to his proposed assessment of an additional tax in the amount of \$1,759.14 for the taxable year ended December 31, 1936, based upon the income of the company for the year ended December 31, 1935.

The Appellant is a foreign corporation doing business as a common carrier by railroad in California and other states with its principal place of business located outside California. During the year 1935 it paid or incurred interest in the amount of \$7,967,104.22 on bonds which are a continuation of bonds issued by it for the acquisition of shares of the Chicago, Burlington & Quincy Railroad Company. In accordance with the rulings of the Franchise Tax Commissioner, Appellant did not include in the net income which served as the measure of its tax any portion of the dividends received by it during the year 1935 with respect to its shares in the railroad company. It did, however, include the entire amount of interest paid or incurred with respect to the bonds above mentioned in its interest expense for the year and, accordingly, deducted the amount of that interest from its gross income in arriving at its net income for the year.

The Commissioner disallowed the deduction from the Appellant's gross income of the interest paid or incurred on the bonds and on the basis of that action levied his proposed assessment. Appellant contends that the action of the Commissioner was improper inasmuch as Section 8 of the Bank and Corporation Franchise Tax Act provided during the period for which the additional tax was assessed that:

"In computing 'net income' the following deductions shall be allowed:

"(b) All interest paid or accrued during the income year on indebtedness of the taxpayer."

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It is arguable under Lewis v. Commissioner of Internal Revenue, 47 Fed. (2d) 32, that the interest in question is not deductible from the Appellant's gross income despite the broad language of Section 8(b) of the Bank and Corporation Franchise Tax Act. Inasmuch as we believe, however, that the action of the Commissioner may be sustained upon an entirely independent ground, it is not necessary to pass upon this contention.

While the Commissioner may have determined the amount of the proposed additional assessment levied against the Appellant through the disallowance of a certain deduction in its return of income, we are required not merely to pass upon the correctness of his action in allowing or disallowing certain items set forth in the return, but rather to pass upon the validity of his action in assessing the additional amount of tax. As we are not concerned with the manner in which he determined an additional amount of tax to be due, but rather with the question whether under the law that additional amount of tax is due, our decision herein is not necessarily controlled by the view which we might adopt as to the deductibility from gross income of the interest paid by Appellant upon its bonds.

The Bank and Corporation Franchise Tax Act proceeds upon the theory that a corporation shall pay a tax measured by its net income from business done within the state for the privilege of exercising its corporate franchise within the state. (Matsor Navigation Company v. State Board of Equalization; 297 U.S. 441; Bay Cities Transportation Company v. Johnson, 8 Cal. (2d) 706.) The Act, accordingly, provides for the determination of a corporation's net income and, if the corporation's business is not done entirely within the state, for the allocation to California of the portion of that net income which is reasonably attributable to business done within the state. Section 10 of the Act suggests certain factors which may be employed to determine the portion of net income attributable to California and authorizes the Commissioner to use those or other factors or such other methods of allocation as are fairly calculated to assign to the state the portion of net income reasonably attributable to business done within this State,

The Commissioner contends that his action in levying the proposed assessment is valid as a method of allocation employed by him pursuant to Section 10 of the Act. Our inquiry, accordingly, is directed to the question whether his action when so considered is fairly calculated to assign to the state the portion of net income reasonably attributable to business done in California and to avoid subjecting the taxpayer to double taxation.

In the determination of the amount of the net income attributable to California, of the unitary business of a foreign corporation such as Appellant, not having a commercial domicile here, the state must exclude from that net income all income from sources outside the state and which does not arise from the conduct of the unitary business. (Fargo v. Hart, 193 U.S. 490.) Such income may be excluded either through its omission from the gross income of the corporation in the computation of the tax or by its inclusion in gross income and its subsequent

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deduction from the net income of the corporation. If the tax is to be measured by the net income of the corporation from business done within the state, it necessarily follows that the expense incurred with respect to the income arising from sources without the state and not incurred in the conduct of the unitary business must not be deducted from gross income, and if it has been deducted it must be added back to ~~the~~ net income figure obtained by making the deduction.

The Appellant did not include in its gross income any dividends received by it during the year 1935 on the shares owned by it in the Chicago, Burlington and Quincy Railroad Company. It does not appear that those shares were devoted to the unitary business conducted by the Appellant in this and other states or that the state could include any portion of the dividends in the measure of its tax. (Virginia v. Imperial Coal Sales Company, 293 U.S. 15; Wheeling Steel Corporation v. Fox, 298 U.S. 193.) We believe, accordingly, that the Commissioner may add to the Appellant's net income as determined by it the amount of interest paid or incurred on the bonds issued by Appellant in continuation of bonds issued to acquire those shares and previously deducted from its gross income.

Insofar as the amount of the additional tax assessed against the Appellant is concerned, it is immaterial whether the amount of interest paid or incurred on the bonds is excluded from the deduction for interest or whether it is included therein but added back to the net income prior to the application of the allocation formula. We are, accordingly, of the opinion that the action of the Commissioner in overruling the Appellant's protest against the proposed assessment of additional tax in the amount of \$1,759.14 for the year ended December 31, 1936, should be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of the Great Northern Railway Company, a corporation to a proposed assessment of an additional tax in the amount of \$1,759.14 for the year ended December 31, 1936 based upon the income of said company for the year ended December 31, 1935, pursuant to Chapter 13, Statutes of 1929, as amended, be and the same is hereby sustained.

Done at Sacramento California, this 15th day of November, 1939, by the State Board of Equalization.

Fred E. Stewart, Member
George Reilly, Member
Harry B. Riley, Member

ATTEST: Dixwell L. Pierce, Secretary